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The CRA's "reasonable expectation of profit" rule allows taxpayers to write off interest on loans used to generate business income

By Gavin Adamson

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On the street, there is a strategy generally known as a "10-8." And some advisors are using this tax-effective strategy to provide life insurance, loan financing or investment leverage for wealthy clients who own profitable businesses.

"For the right person in the right situation, it's a fantastic opportunity," says Mark Halpern, a financial planner with Markham, Ont.-based **illnessPROTECTION.com Inc.** who has put the strategy to use.

The 10-8 name is a catch-all for a strategy that uses life insurance policy loans — either loans made directly on exempt policies or commercial loans with banks using policies as collateral. The name refers to the specific interest rate differential that providers of the strategy will guarantee clients: a 10% annual interest charge on the loan and an 8% annual guaranteed return inside the tax-exempt life insurance policy. In fact, 10-8 is a misnomer because the same principle applies no matter what the differential. It could be 6-4 or 12-10.

At first glance, that differential may seem like a bad deal — until you factor in the potential for interest deductibility on the loan or the relatively low-risk leverage a client

can achieve with the proceeds of the loan.

The manoeuvre involves making use of the **Canada Revenue Agency's** "reasonable expectation of profit" rule, known as the REOP, which allows a taxpayer to write off interest on a loan as long as it is being used to generate income for business or investment purposes.

Clients may use the loans — which can be as low as \$100,000 or into the millions — for cash-flow purposes, acquisitions, investment and other business purposes.

"A new business might see all kinds of opportunities to invest in its business," says Herb Huck, director of professional advisory services at **RBC Insurance** in Toronto. "[The business is] making great returns and it needs insurance. But it doesn't want to tie up its cash in the insurance policy."

A loan on the insurance policy, or using the policy as collateral to take out a loan, allows a business both to acquire insurance and cash flow free. But, Halpern recommends, advisors should first address the client's need for the insurance.

Bruce Cumming, a financial planner with **Cumming & Cumming Wealth Management Inc.** in Mississauga, Ont., has struck this kind of deal for a few clients over the years. A few times a year, he notes, an advisor may come across an opportunity to structure a 10-8 strategy for a client.

The best scenario, according to Cumming: "A client is very wealthy. His or her business has significant cash in it and cash is being regularly generated." The client also needs to be otherwise debt-free, comfortable with leverage and tax-aggressive, he adds.

Under the terms of most tax-exempt life policies, it's possible simply to take out a loan from the policy. Most life insurance providers will allow policyholders to do this. Less common and a bit more complex is a commercial policy loan.

Here's how a commercial loan using an insurance policy as collateral works, in its most simple form. The strategy requires that your client own a universal or whole life insurance policy — any tax-exempt life insurance product that has a cash value separate from the death benefit. (Thus, term policies do not apply.)

Assume your client invests \$100,000 in a life insurance policy. He or she finds a lender who will advance a loan of \$98,000 against the policy. (The 2% new-policy tax can't be advanced.)

The strategy is structured to guarantee an 8% return on a \$100,000 investment, which is mostly funded by the \$98,000 loan. On Day 1, therefore, the client has made \$108,000, Cumming says.

Of course, the strategy costs your client 10% in loan interest, or \$9,800, Mr. Captor evaluation copy the interest deductibility.

Assuming your client has invested the cash for business purposes and is taxed at the highest marginal rate of 50%, he or she can claim half that interest, or \$4,900, back as a deduction on his or her tax return. The client is still netting 3%.

Advisors will find two types of providers for these strategies. One is insurance manufacturers such as RBC Insurance and **AEGON Canada**, which provide policy loans.

Mitch Singer, assistant vice president of tax and estate planning at AEGON Canada in Toronto, notes some clients simply use the policy loan to finance the purchase of life insurance for their companies at lower rates than for term insurance. "You have to have the cash flow to be able to do it," says Singer. "There's a difference between the client who can write a cheque for \$210 every month to pay for term insurance and another who can fund a \$100,000 universal policy all at once."

PPI Financial Group, a national managing general agent, is among a handful of financial services institutions that can set up the more elaborate commercial loan strategy using the policy as collateral. **Manulife Financial Corp.** and **Transamerica Life Canada** are two others.

How is the loan paid off? Some business owners repay the loan as their business grows and their cash flow increases. The deals may also be structured so that part of the death benefit on the policy pays off the loan. "The loan is matched, dollar for dollar, with the policy," explains Cumming.

AEGON Canada says, based on its policy loan figures, about 25% of its universal life premiums are borrowed back; Singer says most of those loans are being used to fund a 10-8 strategy.

The strategy may not be used a lot, but, when it is, it is usually used on a large policy, adds Huck. RBC Insurance has seen its exempt life insurance policies used in the same way.

Although the strategy can work effectively, advisors should exercise caution. They must steer clients through a thicket of tax issues that are best addressed together with an accountant and a tax lawyer. "You'll need them," says Cumming, adding that you also have to have an intimate understanding of your client's business situation.

A policy loan, for example, will be considered a disposition and trigger taxes if the loan exceeds the adjusted cost base of the policy. Generally, a 10-8 strategy is only used in the early years of the contract, before the ACB of the policy is "whittled down," Huck says. "After that, the policy loan is disposition."

Of course, every client situation presents different issues. "A client is doing this for tax efficiency," adds Huck. "Advisors need to understand the client's individual situation to make sure the concept fits and that it will work as illustrated."

Finally, if the 10-8 strategy seems too good to be true, it's possible that one day it may just be. Some insurance companies provide advice from tax accountants to certify the viability of the strategy, but they do not provide a guarantee.

Although various insurance companies have been marketing the strategy in various forms for decades, financial advisors, including Cumming and Halpern, point out that the CRA may rule against its inner workings — either because of the client's particular situation or because of the cogs and wheels that created the structure.

"The whole question focuses on what is 'reasonable'," says Huck, who adds that RBC Insurance provides no guarantees.

Could the CRA deem that a 10% borrowing interest rate is unreasonable? Possibly, but 10-year mortgages are offered at 7.5% from Tier 1 banks today. That's not a comparable rate. But the insurance policy loan is open, meaning that it can be paid off at any time and is offered at a high ratio. A lender would generally charge a premium for those loan characteristics. So, Cumming says, 10% then starts looking reasonable.

Another consideration for your client may be whether a 10% loan is reasonable, given the client's financial situation. The CRA may consider a 10% rate too high if the client is wealthy and creditworthy.

There are several other questions concerning the application of the REOP rule to your client's particular situation. For example, if a client plans to invest the loan funds to realize a potential profit, Cumming says, only an aggressive growth portfolio can be considered to have a reasonable expectation of profit if the client is paying a guaranteed 10% rate of interest.

"So, the client borrows at 10% and puts 40% of the portfolio in bonds that might be making 4%. There's no reasonable expectation of profit [here] — the traditional rule that allows you to make the deduction," he says.

On the other hand, Singer says, if a client is investing the loan from the policy back into a business, an argument can be made that he or she has an REOP based on the return on equity. **IE**



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